DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0166
Adjusted Gross Income Tax
For the Year 1998

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ISSUES

I. Business / Non-business Classification – Adjusted Gross Income Tax.

Authority: Ind. Code § 6-3-1-20; Ind. Code § 6-3-1-21; Ind. Code § 6-3-2-2; I.R.C. § 338; *May Dep't Stores Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001).

Taxpayer protests the reclassification of income derived from an I.R.C. § 338(h)(10) election from business income to nonbusiness income.

STATEMENT OF FACTS

Sub W was a corporation based in Indiana. For several years prior to 1998, Sub W and a number of other corporations were wholly owned by a parent corporation which filed federal consolidated income tax returns; however, Sub W filed separate Indiana income tax returns.

In 1996, Sub W's parent corporation was acquired by another corporation ("Acquirer"). Because Acquirer was not based in the United States, Sub W and other acquired corporations could not file consolidated income tax returns. Taxpayer and two other subsidiaries were eligible to file consolidated returns in Indiana. On November 30, 1997, Taxpayer and other domestic companies owned by Acquirer were contributed to a new company ("New Company'). New Company was eligible to file a consolidated federal income tax return, of which Taxpayer was the reporting company.

On December 26, 1997, Sub W was sold to an unrelated corporation as part of an agreement entered into on November 17, 1997. As a result of the purchase, New Company made an election under I.R.C. § 338(h)(10) to treat the sale of Sub W's stock as a deemed sale of Sub W's assets for the fair market value of the stock. The effect of this election was to cause Sub W to realize income on the deemed sale of its assets and include that income on New Company's consolidated federal income tax return, while Sub W received a stepped-up basis in its assets.

For the first and only time as part of Taxpayer's consolidated group, Taxpayer filed a consolidated return including Sub W and treating the gains from the I.R.C. § 388(h)(10) election as business income. Sub W was not included on a consolidated return or a unitary return for several years (possibly never) prior to Taxpayer's return for the year at issue. The Department, however, determined that the sale of assets was in fact non-business income allocable to Sub W's commercial domicile, Indiana. Taxpayer filed a protest, and a hearing was held.

I. <u>Business / Non-business Classification</u> – Adjusted Gross Income Tax

<u>DISCUSSION</u>

In general, the sale of stock in a corporation ('target corporation"), such as Sub W's sale in this protest, results in income to the shareholders that sold the stock. The target corporation retains its basis in the underlying assets.

Generally, if a corporation liquidates its assets, it is treated as selling its assets to its shareholders at the fair market value of the assets, and realizes income or loss accordingly. I.R.C. § 336. The shareholders receive a basis in the assets received equal to the fair market value of the asset at the time of liquidation. I.R.C. § 334. This shall be called "shareholder treatment."

However, a liquidation of a corporation's assets to its parent is ordinarily results in the liquidating corporation not realizing any gain or loss on the sale of its assets, but the parent retains the basis in the assets that the liquidating corporation had in those assets. I.R.C. §§ 332, 337.

Under I.R.C. § 338(a), a purchasing corporation of a target corporation may elect shareholder treatment with respect to its assets. The assets in the deemed liquidation are treated as having the same fair market value of the stock purchased (subject to certain exceptions not material to this case), and are being treated as being distributed back to the target corporation the day after acquisition. Thus, the target corporation is treated as realizing gain or loss on its assets, and it receives a stepped-up (or stepped-down, in rare cases) basis in its assets.

Under I.R.C. § 338(h)(10), shareholder treatment is permissible for the seller's consolidated group. Thus, the gain or loss from the deemed liquidation under § 338(a) is recognized by the consolidated group. However, unlike regular shareholders who are treated as selling their stock for the value of the assets received in liquidation under I.R.C. § 331, the seller's consolidated group does not realize gain or loss from the sale of stock. In the transaction from which this protest arose, New Company made a 338(h)(10) election with respect to the sale of Sub W, and thus Sub W was treated as liquidating its assets on December 26, 1997, and Sub W was treated as realizing income on this sale for federal income tax purposes, while New Company included this income on New Company's consolidated federal income tax return. The question for Indiana is whether the income from the deemed liquidation of Sub W's assets is business income or non-business income. Further, if the income is treated as business income, an issue arises whether Taxpayer's return fairly reflects Indiana income and whether appropriate remedial measures are warranted.

Ind. Code § 6-3-1-20 provides:

> The term “business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer’s regular trade or business.

Conversely, Ind. Code § 6-3-1-21 provides that “nonbusiness income” means all income other than business income. Under the provisions of Ind. Code § 6-3-2-2, business income of a corporation is subject to apportionment to Indiana, while nonbusiness income is generally allocable to the corporation’s domicile.

In *May Dep’t Stores Co. v. Indiana Dep’t of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001), the court determined that business income was defined by two tests. The first test, the transactional test looks at

> (1) the frequency and regularity of similar transactions;
> (2) the former practices of the business; and
> (3) the taxpayer's subsequent use of the income.

Id. at 658-659.

In *May*, a corporation that owned several large department store chains purchased a rival department store chain. As a result of the purchase, an antitrust case was launched against the corporation. In settlement of the antitrust claim, the corporation sold the assets of one of its divisions. As a result of the asset sale, the corporation realized a gain that it treated as nonbusiness income, allocable to the corporation’s domicile; however, the Indiana Department of State Revenue determined that the income was business income apportionable to Indiana and other states. The court held that, because the sale of the assets was a one-time, extraordinary transaction, the sale did not meet the transactional test for business income. *Id.* at 664. Applying the test from *May*, the deemed asset sale of Sub W did not meet the transactional test because the deemed sale of Sub W’s assets was a one-time occurrence, rather than part of Sub W’s regular business activities.

The second test, the functional test, “dictates that acquisition, management, use or rental, *and* disposition of property must constitute integral parts of regular business operations.” *Id.* at 660 (emphasis added). In *May*, the court noted that the sale of the assets of the division in question was done to benefit a competitor, rather than the corporation that previously owned the division. As a result, the sale could not have been an integral part of the corporation’s business, and therefore the sale failed to meet the functional agreement. *Id.* at 665.

Here, the property from which Sub W realized the income at issue was clearly part of its overall business and was generated as part of its overall business enterprise (goodwill). As such, the income from the deemed sale of Taxpayer was business income within the meaning of Ind. Code § 6-3-1-20.

However, Sub W’s situation was an unusual situation under which Indiana law is not entirely clear. Here was Sub W’s scenario:

1989-1996—Sub W is owned by a previous owner. Sub W is part of a federal consolidated return but files separate Indiana returns.

1996- November 30, 1997—Sub W is owned by Acquirer. Sub W is ineligible to be part of a consolidated group; however, three subsidiaries are eligible for consolidation for Indiana purposes. (Taxpayer, Sub 1, Sub 2).

November 17, 1997—An unrelated company agrees to purchase Sub W.

November 30, 1997—Sub W's and another subsidiary's (Sub 3) ownership are changed within their affiliated group to New Company, removing the obstacle that prohibited its inclusion on a consolidated return.

December 1, 1997-December 26, 1997—Sub W is part of an affiliated group with Taxpayer, Sub 1, Sub 2, and Sub 3.

December 26, 1997—Sub W's sale to an unrelated third party is completed.

December 27, 1997-March 30, 1998—Taxpayer, Sub 1, Sub 2, and Sub 3 are part of an affiliated group.

Under federal law, it is clear what happens: Taxpayer, Sub 1 and Sub 2 include all of their income on a consolidated return. Sub 3 files a separate return for the period prior to December 1, and includes its income on or after December 1 on a consolidated return. Sub W files a separate return for the period prior to December 1, includes its income from December 1 to December 26 on the consolidated return, and then files yet another short-year return (or includes its income on its buyer's affiliated return) for the period after December 26.

Under Ind. Code § 6-3-2-2(*l*), the Department may take various remedial measures to fairly represent Taxpayer's and Sub W's income from Indiana sources for Taxpayer's and Sub W's business activity. In addition to three methods listed in subsection (*l*), the Department may also employ "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." Ind. Code § 6-3-2-2(*l*)(4).

While the general rule for consolidated returns is that the "standard method" (i.e., the members of the consolidated group are considered as one business for tax purposes), the current case requires a "stacked" method (i.e., each company Indiana income for Indiana purposes is determined separately, then added together to reach the consolidated group's overall Indiana income) with respect to Sub W due to the normal method's significant underreporting of Indiana income. Sub W historically had an Indiana apportionment factor of approximately 90 percent. Sub W sought to offset its income with business deductions for salaries, equipment, and other necessary expenses for its entire history until November 30, 1997. However, Sub W's sale, agreed to prior to its membership in the consolidated group, resulted in a $120,000,000 gain—derived largely from Indiana sources—transforming into a $9,000,000 gain (basically, computing the income and apportionment factors with Sub W in the consolidated group, and then without Sub W in the consolidated group). In effect, Sub W has sought to benefit from deducting 90 percent of its expenses for Indiana tax purposes for years, but the resulting income generated by the sale of its assets—the converse of its deductions—is only reported at about eight percent of Sub W's total income. Treating Sub W as a separate entity from the rest of the consolidated group would fairly reflect the income of Sub W from Indiana sources in two ways. One, it would reflect the fact that Sub W had always been a separate filer for several years, even when it was eligible to file federal consolidated returns, and had no tax relationship with the other members of the consolidated group other than 26 days in which Sub W's sale to a third party was a foregone conclusion. Second, it would prevent the dilution of Sub W's income, mostly derived from Indiana sources, by increasing the apportionment factor for the income in question from roughly 8 percent to 90 percent—its historical apportionment factor. This method is the best reflection of Sub W's and Taxpayer's income from Indiana sources.

FINDING

Taxpayer's protest is sustained with respect to the classification of income as business income. Taxpayer's protest is denied with respect to the apportionment methodology used by Taxpayer rather than the method set forth in this letter of findings.

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